Financial Sector Led Growth Initiative

The Message of the Financial Sector Led Growth Initiative

- Financial sector openness offers two fundamental benefits:

  » ***Growth***

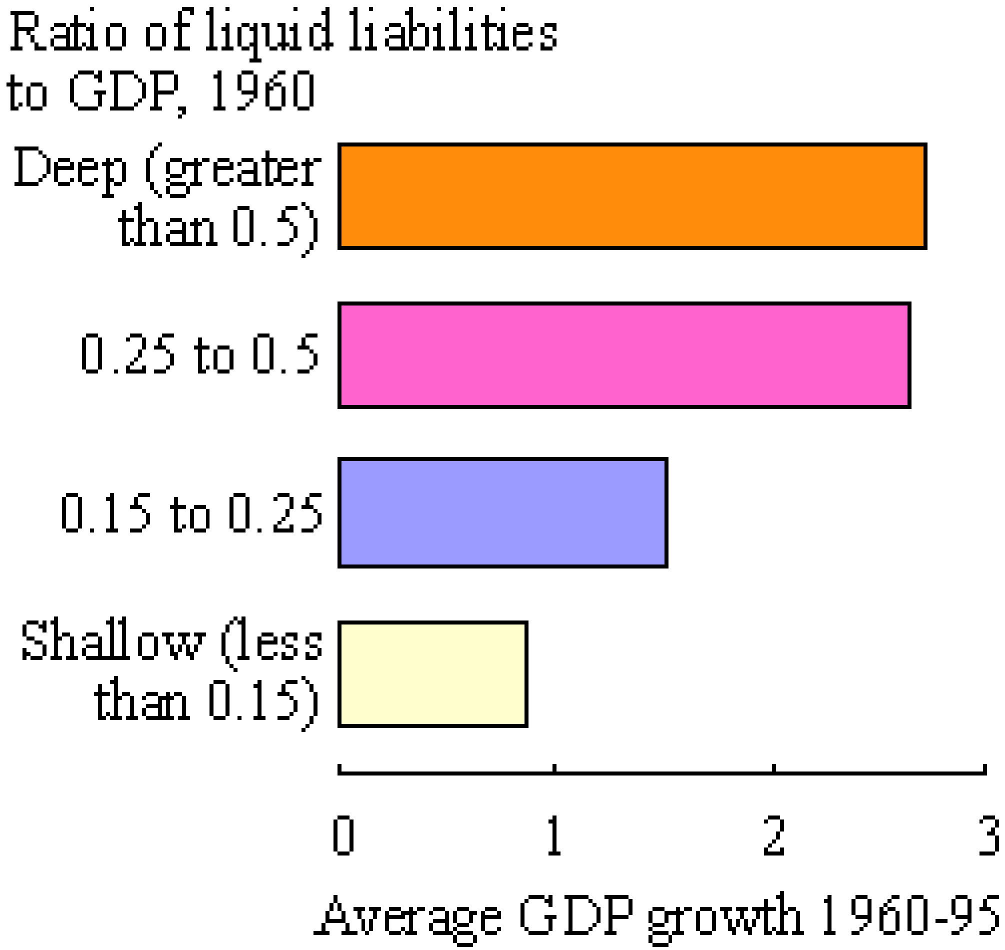
  » ***Stability***

Empirical Evidence for Financial Sector Led Growth

Studies show that liberalizing and deepening the financial services sector, in conjunction with strong legal, supervisory and regulatory institutions, is associated with higher rates of growth, particularly in developing countries:

- Countries who liberalize the financial services and telecommunications sector were shown to increase growth 1.5 percentage points faster than others. This rate is 2.5 percentage points when looking at developing countries alone. (Matoo et al., "Measuring Services Trade Liberalization and Its Impact on Economic Growth: An Illustration", World Bank/IMF, August 2001)
- Doubling the ratio of private credit to GDP is associated with an average long-term growth rate almost 2 percentage points higher. (World Bank, *Finance for Growth*, 2001)

Financial Depth Generates Subsequent Growth



Source: World Bank, *Finance for Growth*, 2001.

How does financial sector development increase growth?

A liberalized and competitive financial sector can promote growth of output and income by:

- Channeling investment to their most productive uses
- Enhancing capital accumulation
- Increasing the productivity of investment, not just increasing investment
- Minimizing transactions costs through trading of risk, monitoring managers, and mobilizing savings

Benefits Beyond Growth

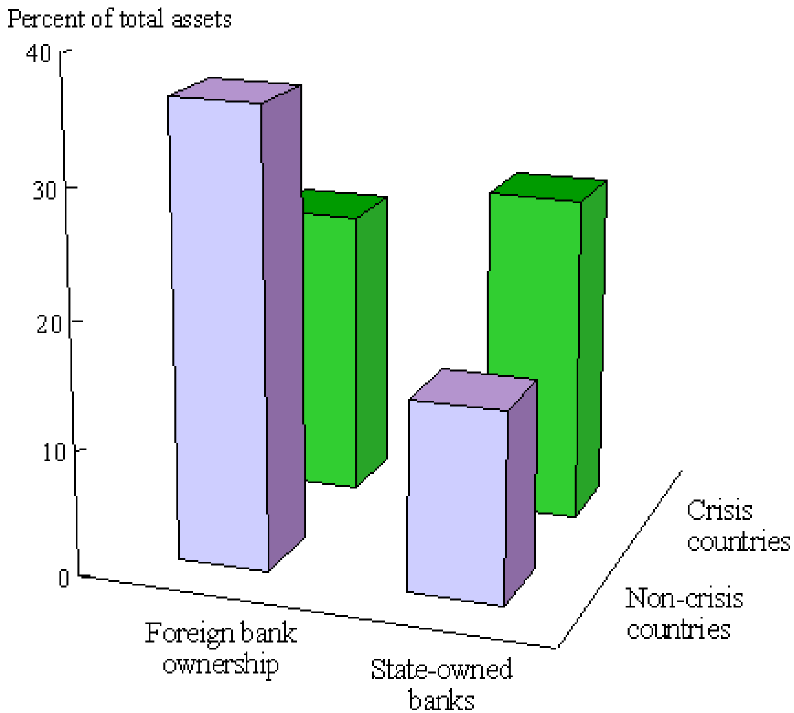
- Widens access to external finance and expands local markets (more sectors, more services). Access to financial services is more important than who provides them
- Increases stability through diversification of risk.
- Promotes efficiency and transparency
- Strong supervisory and regulatory systems ensures constructive incentives for financial market participants
- Introduces technical expertise, capital for new investment and identification of development opportunities
- Introduces of best practices for risk management, credit analysis, maturity management and training for local management and staff

Empirical Evidence for Financial Sector Led Stability

Studies also show that liberalizing and deepening the financial services sector, in conjunction with strong legal, supervisory and regulatory institutions, is associated with increased stability in domestic financial sectors:

- “Foreign participation with fair competition in financial services is a key ingredient in building a reliable and durable financial system. This in turn builds confidence, fosters growth , and is therefore crucial for stability.” (Kireyev A., “Liberaltization of Trade in Financial Services and Financial Sector Stability”, *IMF Working Paper*, June2002)

Comparing the share of foreign and state ownership in crisis and noncrisis countries



Source: Barth, Caprio and Levine. 2001.

The level of foreign ownership in a financial sector can contribute to crisis avoidance. Foreign bank entry can strengthen the financial sector and increase stability. In fact, foreign entry has been associated with systemwide improvements in the quality of regulation and disclosure.

What are the steps to liberalization?

- Remove any impediments to an open, transparent financial sector
- Strengthen supervision or reform regulations to create the right incentives for growth oriented sector

What do we mean by liberalization?

- By “liberalization” we mean opening domestic markets to FDI in financial services and according foreign and domestic firms equal treatment. This is distinct from opening the capital account.

Barriers to Realizing Growth

- Limitations to levels of foreign equity participation
- Limitations to the form of establishing commercial presence (branches vs. subsidiaries)
- Lack of access of foreign participants to local financial networks (e.g. ATMs)
- Economic needs test
- Quantitative limits on foreign presence or total number of institutions
- Non-transparent financial regulations
- Undefined/non-public licensing requirements for financial institutions
- Limitations on scope of business (no deposit taking, trading in government securities)
- Client limitations (e.g. only foreign invested firms)
- Requiring local establishment even for advisory/informational service

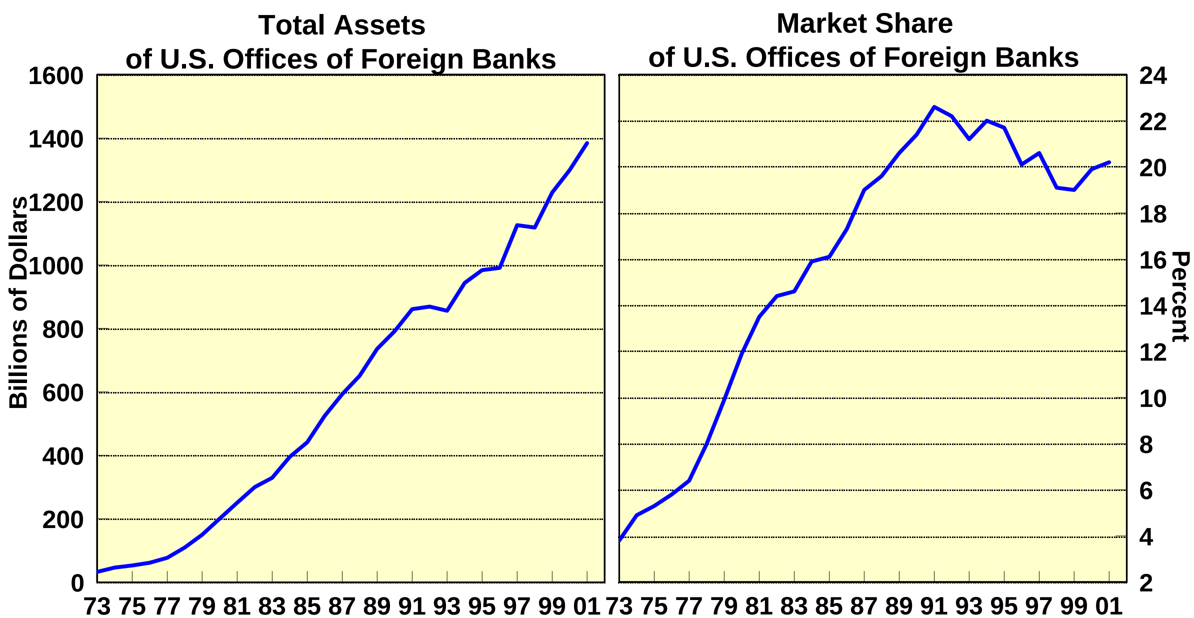
History of U.S. Liberalization

- Promoting innovation in the banking sector
  - recognizing foreign banks*
  - promoting domestic competitiveness
  - resolving banking sector problems
  - improving market incentives and supervision
- Strengthening securities markets
  - improving disclosure and monitoring
  - promoting competition and efficiency

*Foreign banks are those with foreign ownership > 25%.

Foreign Financial Services Providers’ Participation

FOREIGN BANK PRESENCE IN U.S. MARKET



Note: U.S. Offices of Foreign Banks include foreign bank branches and agencies, New Your investment companies (through Sept. 1996) and U.S. commercial banks of which more than 25 percent is owned by foreign banks, and International Banking Facilities. Market share reflects share of total of domestically-owned plus foreign bank assets.

- Swift and significant penetration.
- Market share stabilized as U.S. banks responded.

Benefits of Greater Foreign Participation in U.S.

- Introduced innovations that allowed US banks to increase international lending (new pricing)
- Competitive pressure improved U.S. banks' domestic performance.
- Increased capitalization of the banking system.
- Provided assistance in resolving problem domestic banks.

Promoting Domestic Competitiveness

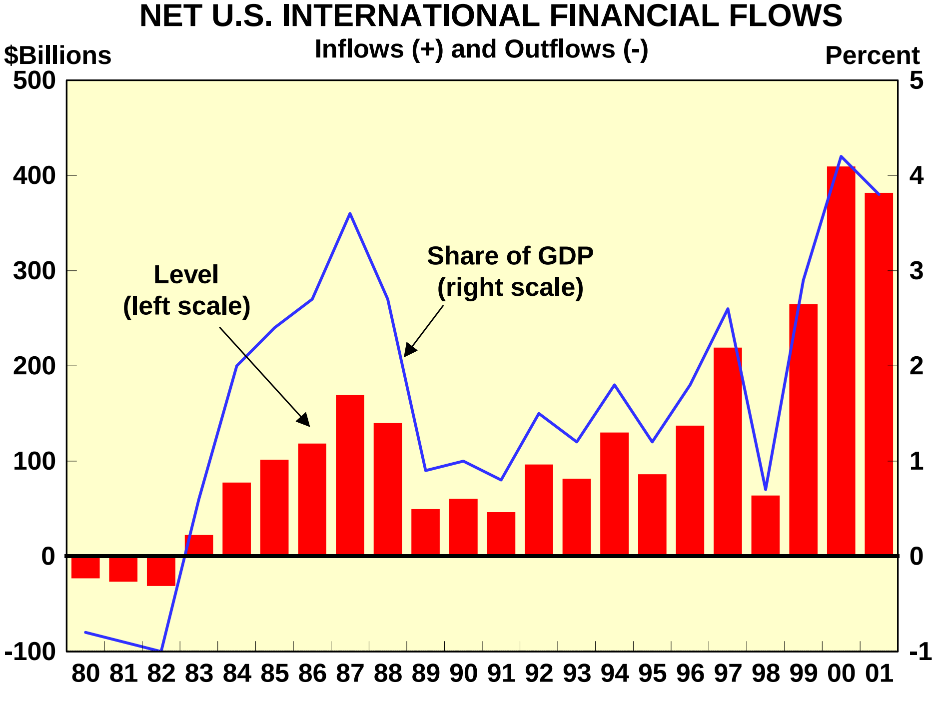
- Eliminated interest rate ceilings for consumers and depositors.
- Allowed banks and thrifts to offer new deposit and lending products.
- Allowed interstate banking and affiliations among broad financial services companies.
- Prohibited anticompetitive brokerage commission setting.
- Strengthened audit system.

Allocational Efficiency Increased

- Increased productivity in the banking and securities sectors
- Strong banks merged, grew
- Improved business and consumer access to bank credit facilitated faster small and new business growth, more consumer finance options

Investment Environment Became Increasingly Attractive

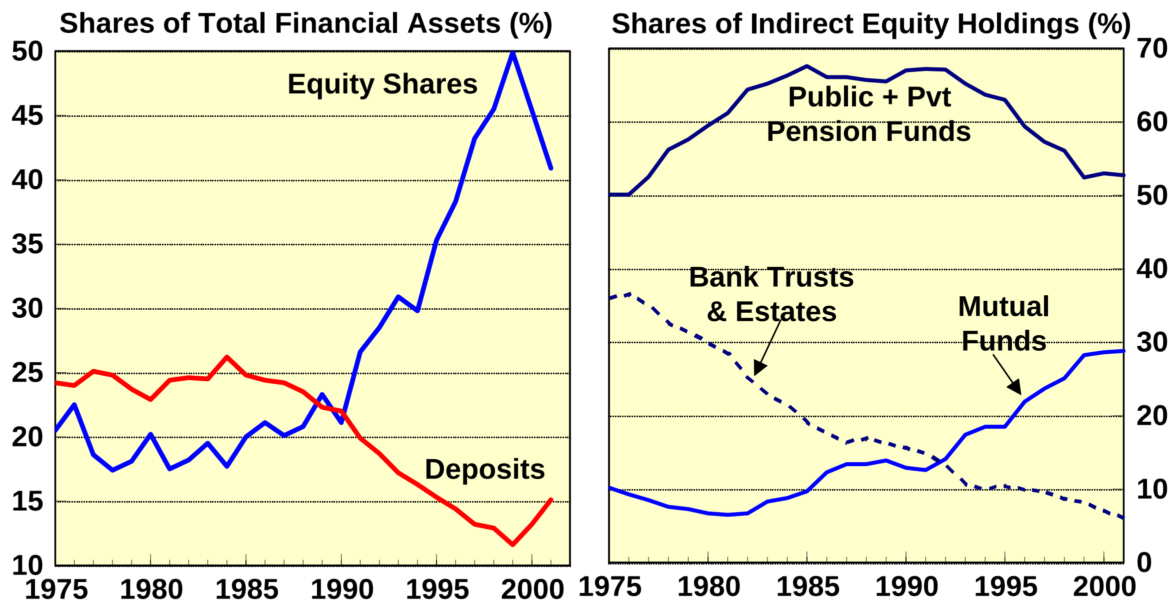
- Liberalization may have increased the volume of funds available for productive investment.



Benefits to Consumer Finance

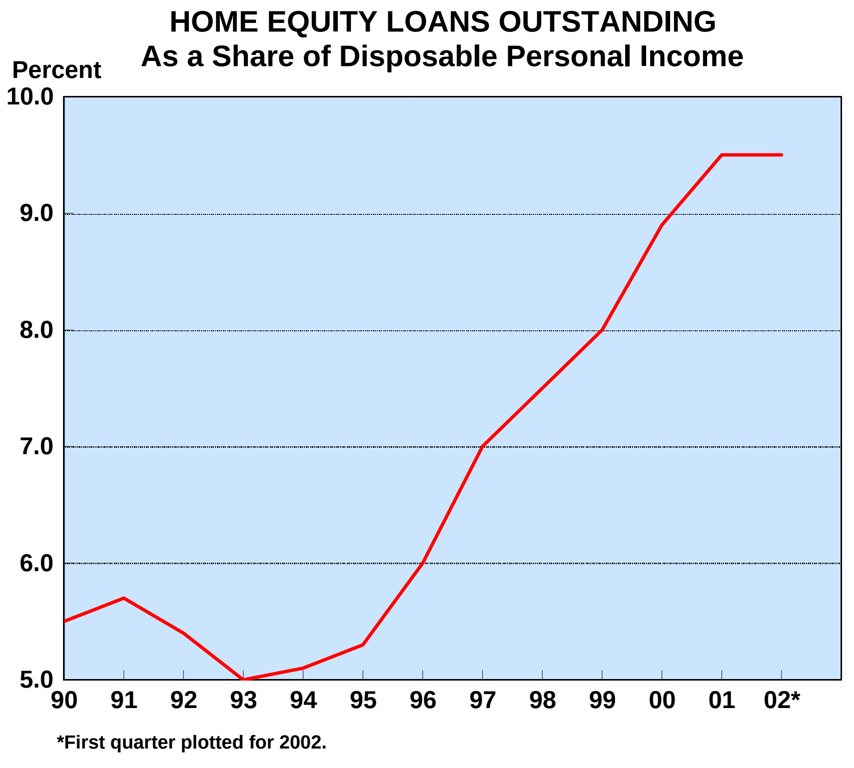
- Declining transactions costs
- Broader range of investment options:
  - money market mutual funds
  - NOW accounts
  - 401(K)s and IRAs
- Transformed household asset allocation

COMPOSITION OF HOUSEHOLD FINANCIAL ASSETS



Note: Equity shares include both directly and indirectly held shares. Indirect equity holdings are held through bank trusts and estates, life insurance companies, private pension funds, state and local retirement funds, and mutual funds.

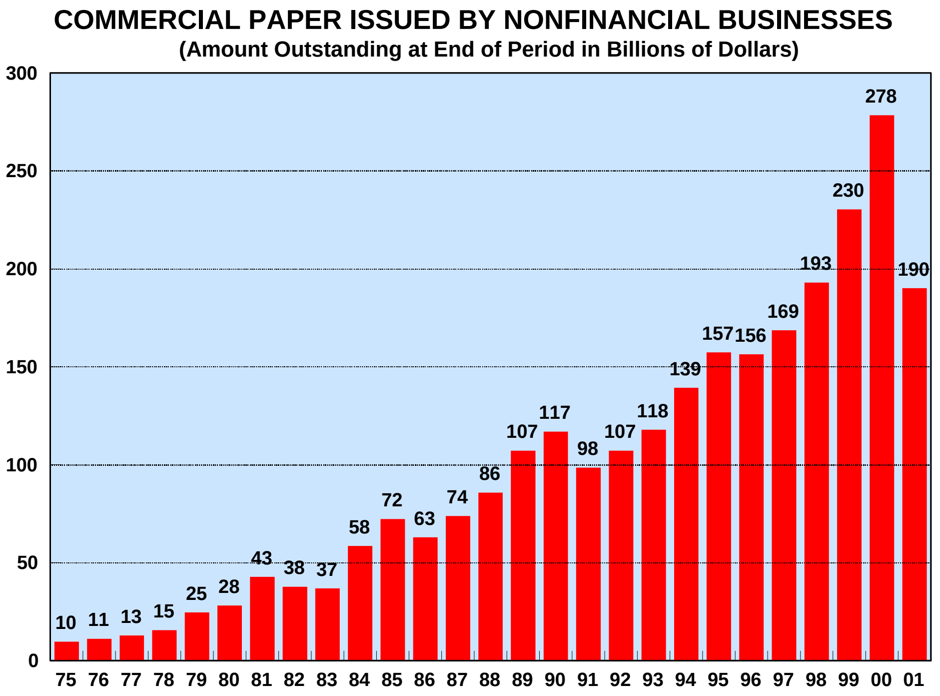
U.S. Experience: Benefits to Consumer Finance



- Increase in credit availability:
  - increased secondary mortgage credit
  - home equity loans
  - credit cards

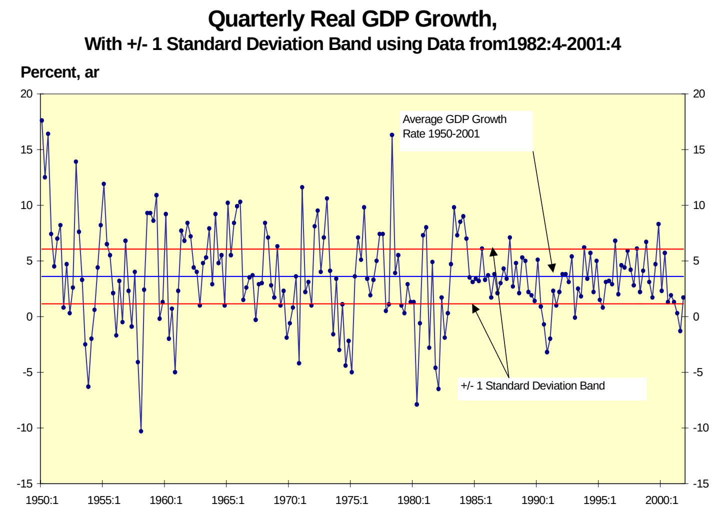
U.S. Experience: Benefits to Corporate Finance

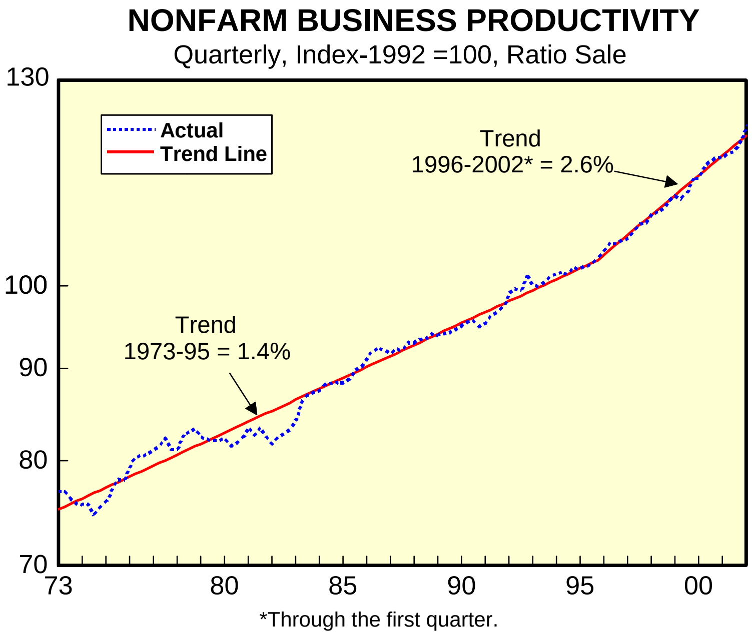
- Wider range of financial instruments available to businesses -- especially small businesses and start-ups.
  - Growth of the commercial paper market
  - Increased market for venture capital
  - NASDAQ made it easier to execute IPOs
  - Rise of the junk bond market
- Enhanced business sector's ability to raise funds for investment.



Macroeconomic Benefits

- Stability increased



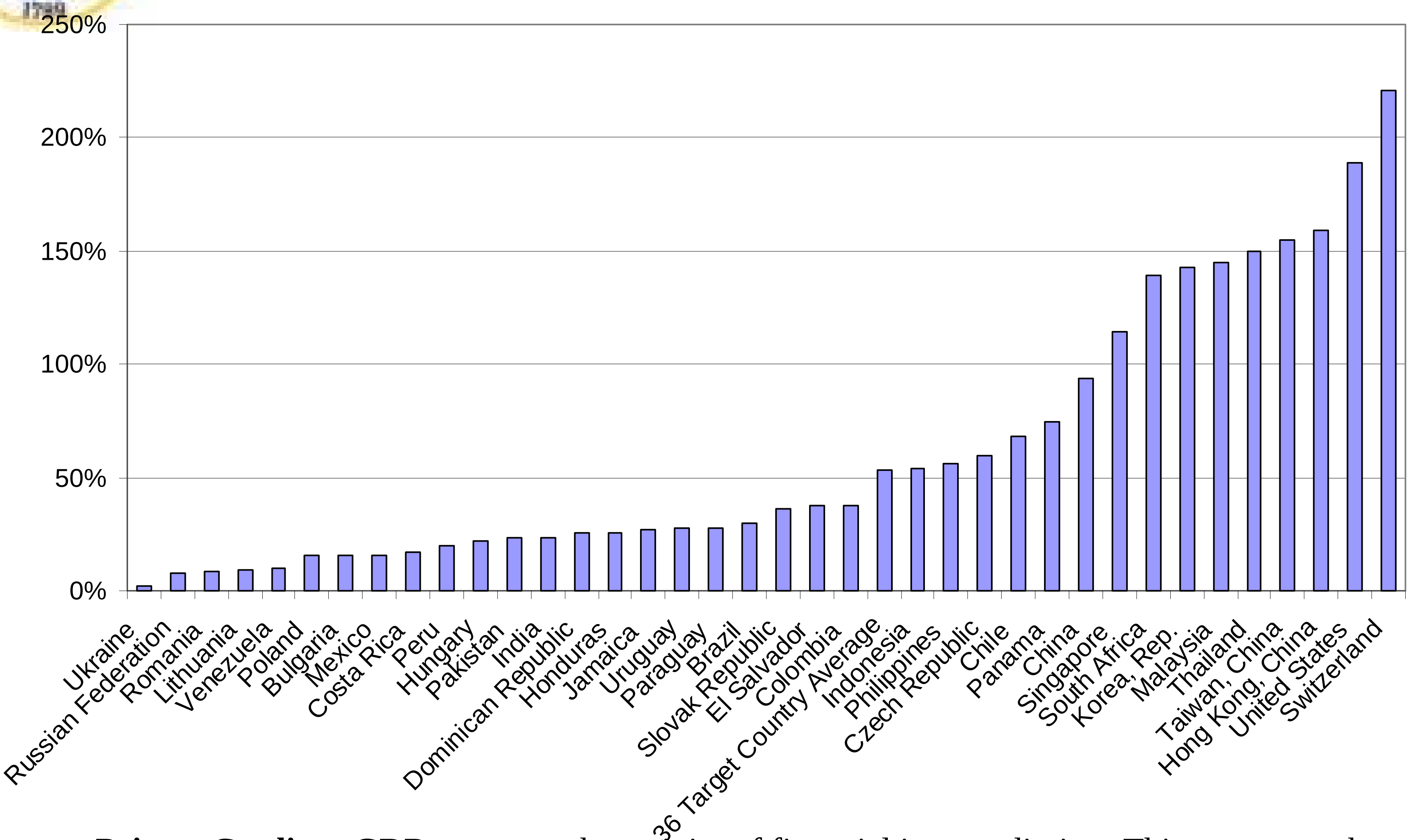


- Productivity growth accelerated

Measuring Success

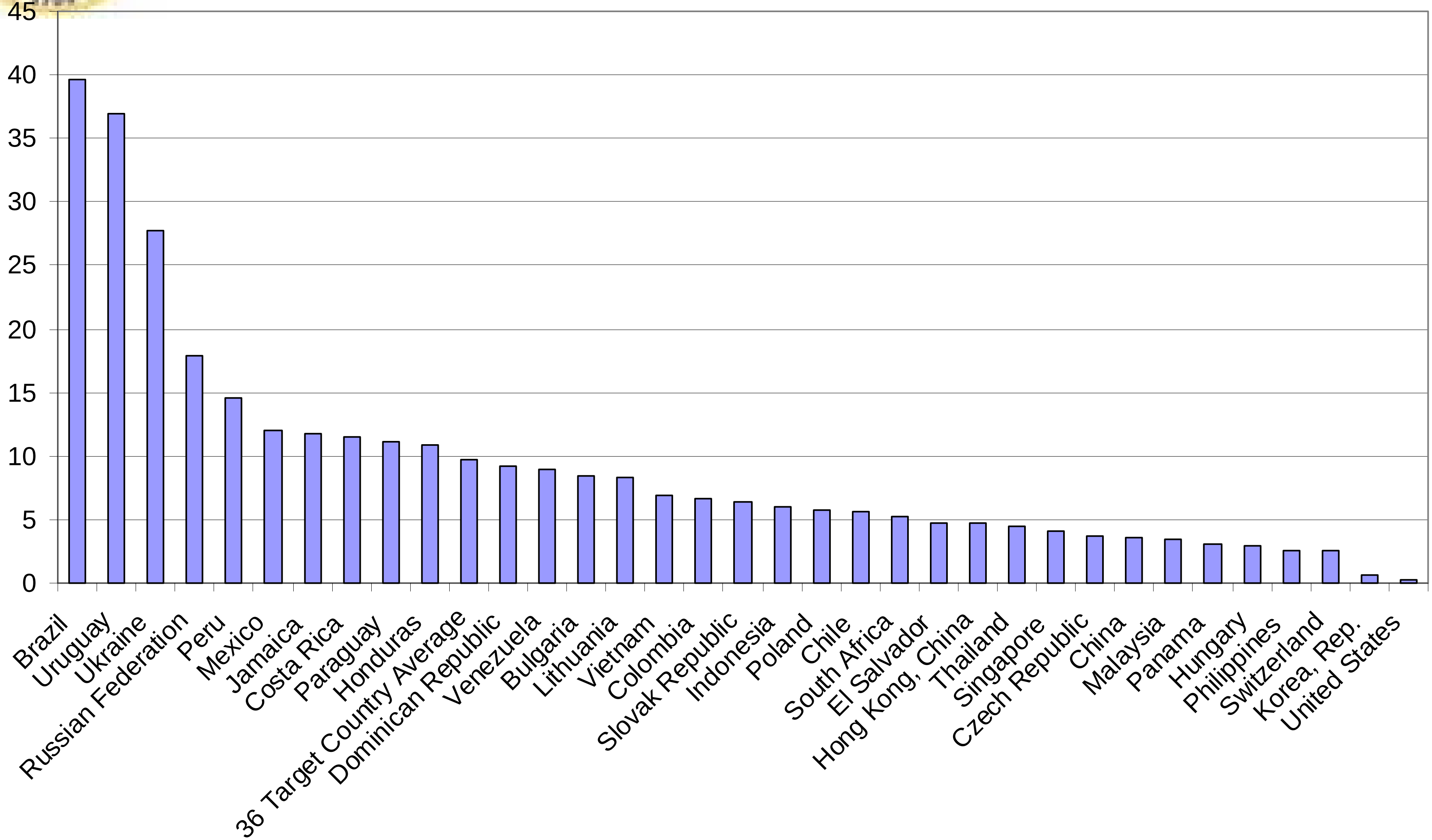
- Quantitative measures: private credit to GDP, interest rate gap, liquid liabilities to GDP, stock market capitalization to GDP, financial market sophistication, and financial regulation and supervision.
- Greater access to credit for consumers and businesses.
- Commitments at the WTO.

Private Credit to GDP

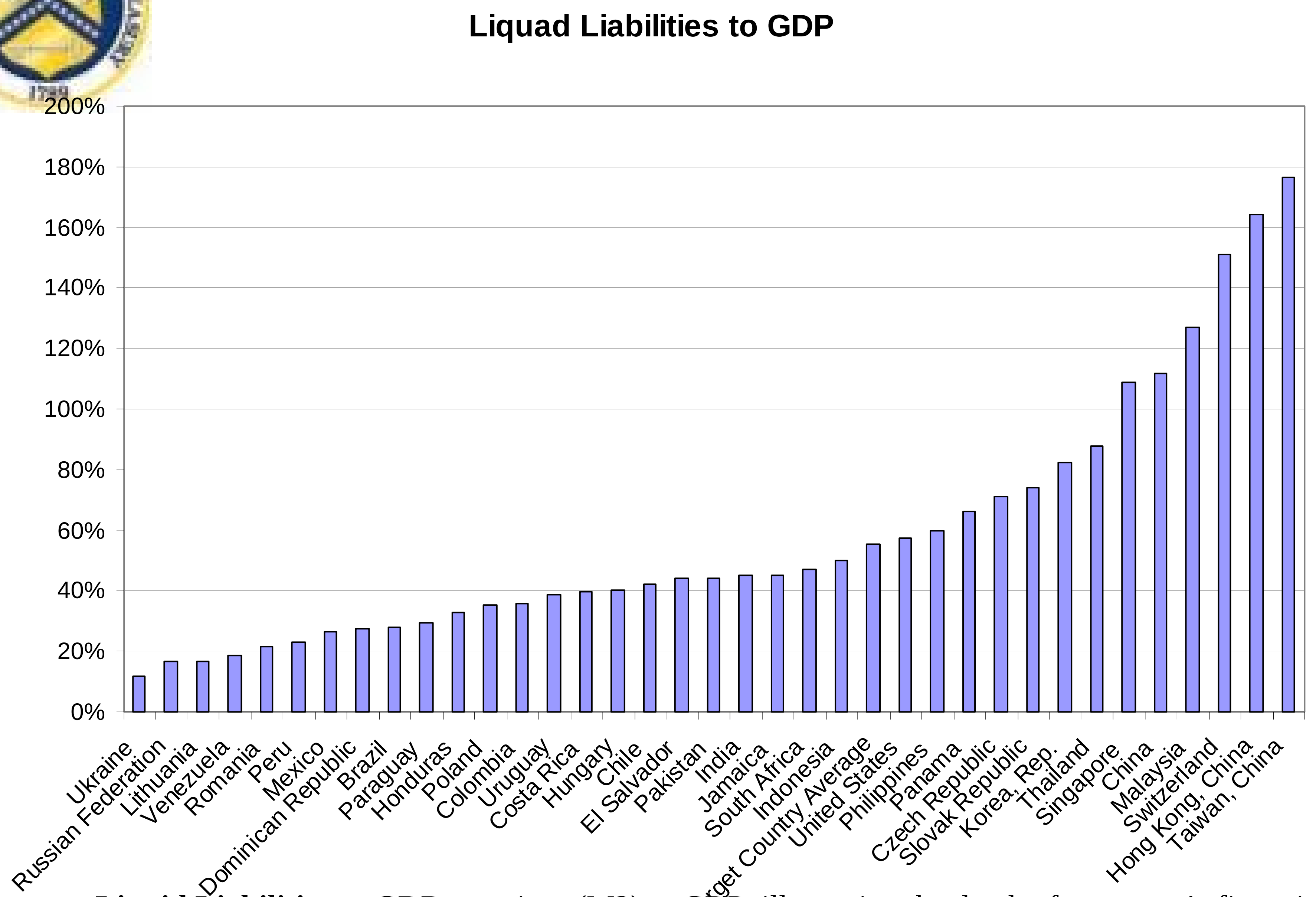


Private Credit to GDP measures the activity of financial intermediaries. This measures the activity of financial intermediaries in on e of its main functions: channeling savings to investors.

Interest Rate Gap

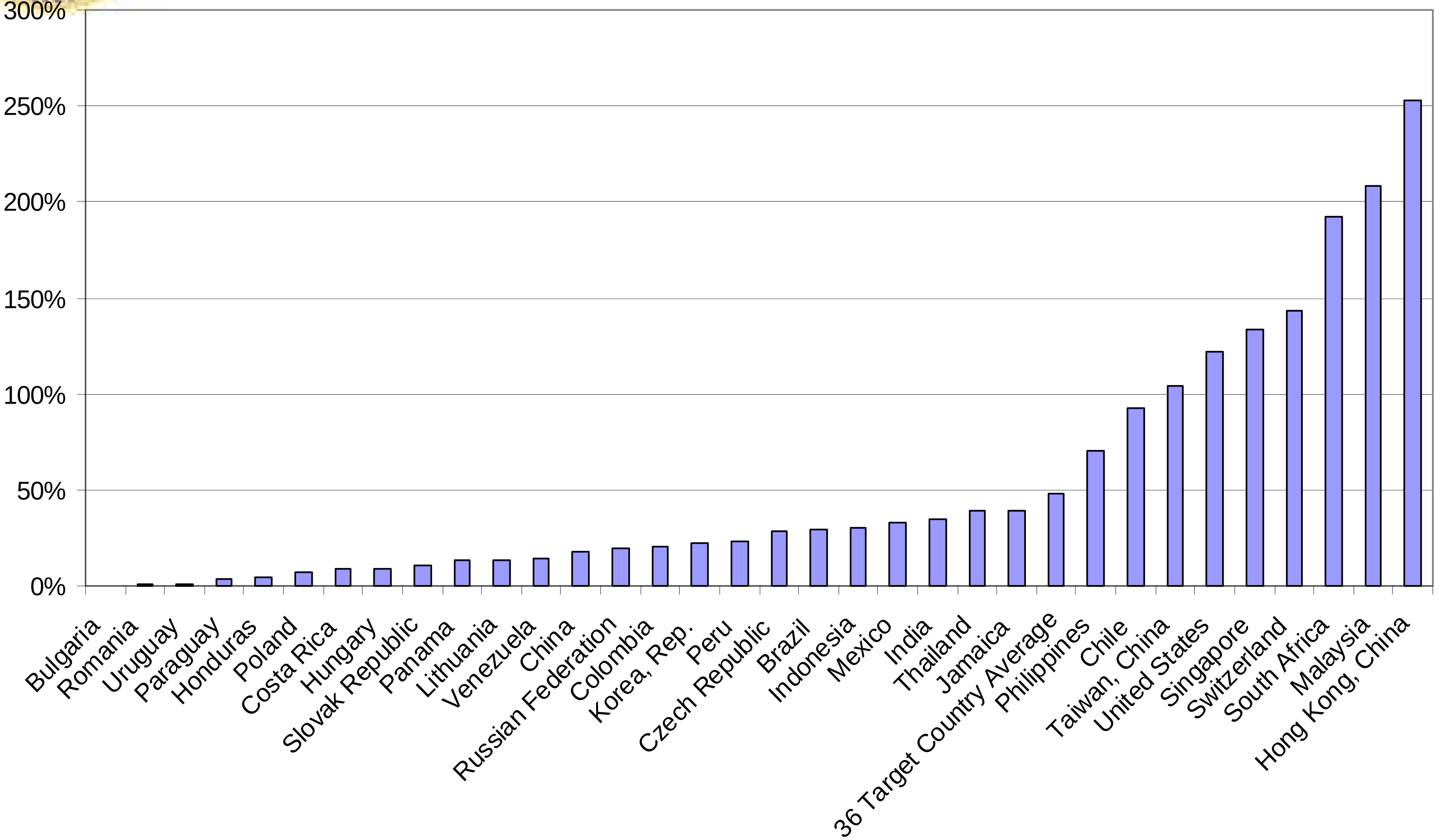


Interest Rate Gap is the gap between lending and deposit rates. It measures the efficiency of bank's ability to channel funds from savers to investors.



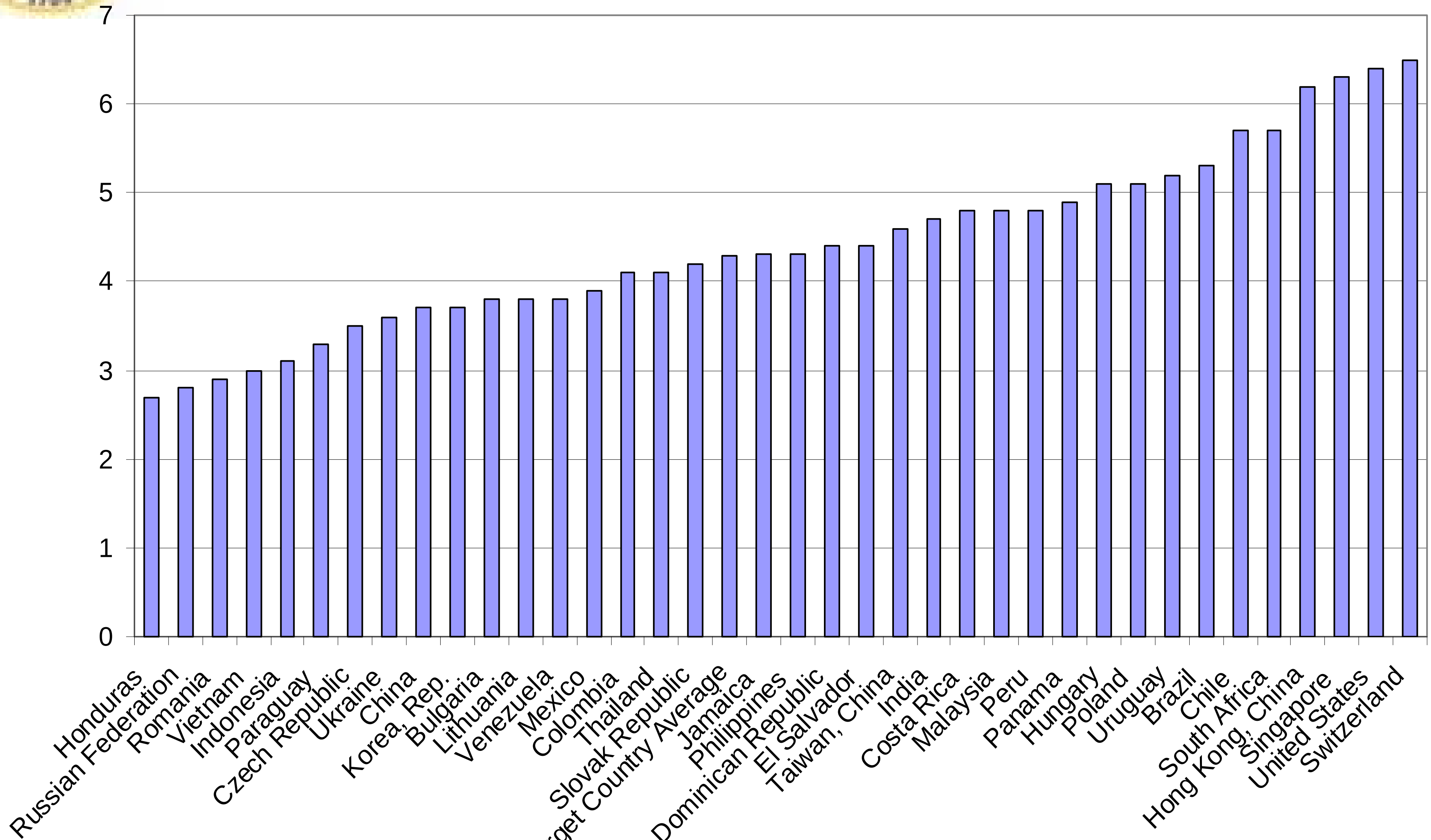
Liquid Liabilities to GDP examines (M2) to GDP, illustrating the depth of a country's financial payments system.

Stock Market Capitalization to GDP



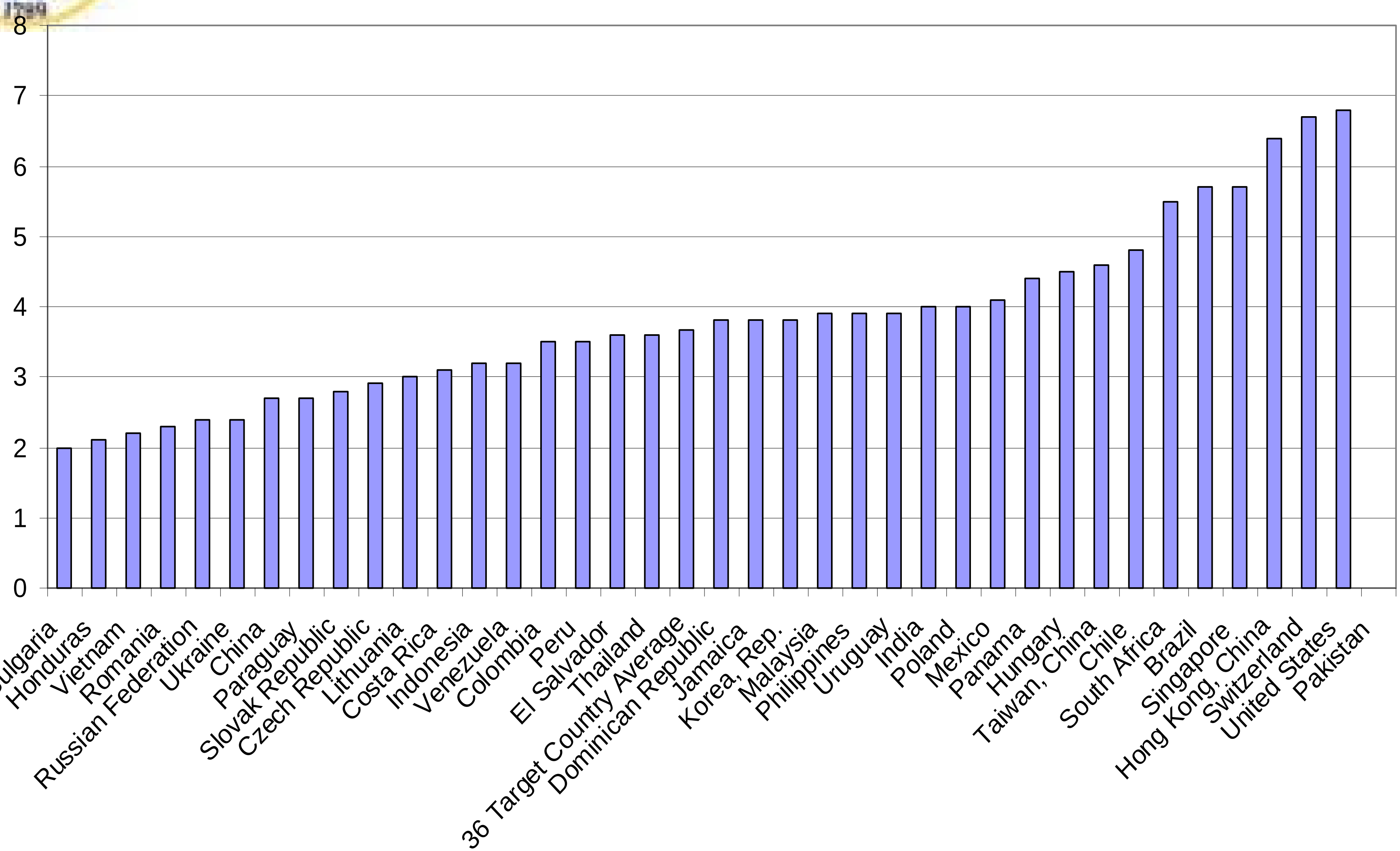
Stock Market Capitalization to GDP measures the depth of a country's private capital relative to the economy and reflects the potential for trading risk and boosting liquidity within the country.

Financial Market Regulation and Supervision (1 to 7)



This measure provides an estimate of the degree to which the regulatory and supervisory regimes currently in place can support financial stability. A score of 1 indicates that financial regulations and supervision are inadequate for financial stability, while a score of 7 indicates that they are among the world's most stringent.

Financial Market Sophistication (1 to 7)



Financial Market Sophistication estimates the a country's level compared to the most highly developed financial markets (From World Economic Forum Survey).